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LATENTS ARE NOT LOVELY

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There is not a well developed body of case law involving a surety's liability for latent defects. Some jurisdictions have not ruled on the subject, while others have only rendered a few cryptic opinions. In Florida, the issue of whether a surety may be held liable for latent defects is a controversial issue. Two district appellate courts in Florida have written conflicting opinions on the issue, and the Florida Supreme Court has not resolved the conflict. Thus, the controversy remains.

This paper provides an overview of four subjects: (i) the conflicting Florida opinions and their progeny; (ii) other jurisdictions' treatment of the issue; (iii) elements generally necessary to hold a surety liable; and (iv) the defenses available to a surety in a latent defects case.

TYPICAL FACTUAL BACKGROUND

The typical facts surrounding a latent defects surety case are something like this:

Billy Joe Contractor bids and is awarded the contract to build Cow Pie County's new vocational school, Silo-Technical Institute. In order for Billy Joe to get the contract, he is required to provide a statutory performance bond, which he obtains from the Gigantic Surety Corporation. The building is completed, the county pays Billy

Joe and everything is great. One year later, the roof on the Silo-Technical building collapses due to a latent defect. Billy Joe is out of business, the school is without a roof, and the only thing that the county has going for it is that one of its attorneys has discovered in the basement of Cow Pie County Courthouse the old performance bond written by the Gigantic Surety Corporation.

Thereafter, the county sues Gigantic Surety on its performance bond and now the local circuit court is faced with deciding what entity should suffer the loss due to the contractor's breach.

I. **A SURETY IS NOT LIABLE FOR LATENT DEFECTS BECAUSE A PERFORMANCE BOND IS NOT INSURANCE AGAINST LATENT DEFECTS.**

As noted above, the issue of whether a surety may be liable for latent defects is an unresolved issue in Florida. The first case that addressed the issue in Florida held that performance bonds do not cover an owner's loss caused by a latent defect.

In Florida Board of Regents v. Fidelity & Deposit Company of Maryland, 416 So.2d 30 (Fla. 5th DCA 1982), the Board sought to hold the surety responsible under its performance bond for alleged latent defects which were first noticed after the one year statute of limitations for suit under the bond had expired. The trial court entered summary judgment for the surety. The Florida Fifth District Court of Appeals affirmed the summary judgement, not only because the lawsuit was filed after the statute of limitations had run, but

also because the performance bond did not insure against the latent defects described in the suit. The court held that when the architect certifies the building as substantially complete, and the owner accepts the building, then the contractor is deemed to have fully performed. When the building is completed, the surety is relieved from any further responsibility. The purpose of the performance bond is to insure physical completion of the work upon default and to insure against losses which the owner may suffer if performance default occurs, not losses due to latent defects.

II. A SURETY MAY BE HELD LIABLE FOR LATENT DEFECTS UNDER A PERFORMANCE BOND WHEN THE PERFORMANCE BOND INCORPORATES THE UNDERLYING CONTRACT BETWEEN THE CONTACTOR AND THE OWNER.

Two years after the Florida Board of Regents case was decided, another Florida district appellate court criticized the decision and held that a surety may be liable for latent defects if certain conditions were met.

In School Board of Pinellas County v. St. Paul Fire and Marine Insurance Company, 449 So.2d 872, (Fla. 2d DCA 1984), the County brought an action against a contractor and its surety seeking damages from alleged latent defects which the County claimed it did not discover until some two years after the building had been completed and accepted by its architect. The trial court ruled that the performance bond did not cover the types of claims made by the County after the

County's architect accepted the building, which decision the County appealed. The appellate court reversed the summary judgment in favor of the surety and held that the performance bond incorporated by reference the contract between the County and the contractor, and the performance bond was given to insure the County that the contract would be completed in accordance with the plans and specifications for the building. Thus, if the County can prove: (i) that the contractor breached its contract by failing to construct the building in accordance with the plans and specifications, (ii) that the County was unaware of the defects at the time of its acceptance, and (iii) that such defects were not apparent under reasonable inspection, then the surety may be held liable for such latent defects to the same extent that the contractor is liable. Although the court held that a surety may be liable for latent defects, it did not address the application of the statute of limitations defense.

Courts in other jurisdictions have also found sureties liable for latent defects when the performance bond incorporates the underlying obligation.

In Elliott Consolidated School District v. Busboom, 227 F.Supp. 858 (S.D. Iowa 1964), the School District sued the contractor and its surety based on defects in the roof of an elementary school building. The surety asserted that it was exonerated from liability because the school district had paid for the work and had issued certificates of acceptance

releasing the contractor from any further duty. The court held that the performance bond specifically incorporated the contract between the school board and the contractor, and the contract specifically provided that payment or certificates were not acceptance of defects in workmanship or failures to comply with specifications of the contract. Therefore, the surety could not assert the defense of acceptance against the District.

In City of Seaside v. Randalls, 180 Pac. 319 (Oregon 1919), the city sued the contractor and its surety for defects in a sewer system. The surety's bond was conditioned on the premise that the surety should "truly keep, perform, and fulfill all and every condition of the covenants, conditions, stipulations, and agreements in said contract mentioned to be performed and fulfilled." The court held that this provision specifically incorporated the contract between the city and the contractor. Therefore, the portion of the city's contract which expressly stipulated that the city engineer had no authority to release the contractor from the specifications of the contract applied to the surety. Therefore, the city engineer's acceptance of the work was not a waiver of the city's rights against the contractor or the surety.

Haywood County Consolidated School System v. United States Fidelity and Guaranty Company, 257 SE 2d 670 (N.C. Ct. App. 1979), involved a contract for the installation of plumbing work. In performing the work, the contractor

installed a defective pressure valve. As a result of the installation of the defective valve, a significant amount of water damage occurred. The surety denied that the terms of the bond required it to pay for these repairs. The contractor's general liability policy, in effect while the work was in progress, had been cancelled prior to the blow-up, and the contractor was adjudicated bankrupt. The trial court held that the surety must pay for the repairs to the damaged school. Upon appeal, the court construed the bond in the construction contract together to determine the intent of the parties and found that the surety's obligation under the performance bond was to "well and truly perform and fulfill all of the undertakings, covenants, terms, conditions and agreements of the contract." This duty included the contractor's responsibility to carry liability insurance. As a result, the court held the surety liable for damage that resulted because the contractor failed to carry liability insurance.

III. ELEMENTS NECESSARY TO CLAIM AGAINST A SURETY.

Under the Pinellas County case, and cases reaching a similar result generally, an owner must satisfy three conditions in order to hold a surety liable under a performance bond for latent defects. The owner must demonstrate:

(i) BREACH OF THE CONTRACT BY THE CONTRACTOR. This element reflects the well established principle of suretyship law that the contractor must be in default under the contract in order for the surety's obligations under its bond to arise. The bond guarantees the faithful performance of the contract by the contractor, and thus, the surety cannot be held liable unless and until the principal is in default. Sterns, Law of Suretyship, Section 7.1 at 200; Section 8.11 at 262 (5th Ed. 1951) cited in The Surety's Liability for Latent Defects, Warin.

(ii) THE OWNER IS UNAWARE OF THE DEFECTS AT THE TIME OF ACCEPTANCE. This second element pertains to whether an owner has knowledge of a defect, and, thus has waived its rights to claim that what it has accepted deviated from the contract.

If an owner accepts work with knowledge that it had not been done according to the contract or where the defects were discoverable by reasonable inspection, the owner's acceptance may be a waiver of the defective performance. On the other hand, if the work was not performed according to contract, an acceptance of the work and payment of the contract sum by an owner who

was without knowledge of the latent defects, would not necessarily constitute a waiver or an estoppel claims for such latent defects. The School Board of Pinellas County, Id at 873-874.

(iii) DEFECTS WERE NOT APPARENT UPON REASONABLE INSPECTION. This third, and final, element is related to the second. The second element states that an owner must not know about the defects at the time of its acceptance. This third element requires that the owner inspect the property. The critical distinction between a defect which is latent and one which is patent is its susceptibility to detection; or whether or not the defect is discoverable by a "reasonable" inspection. For the most part, reasonable is matter to be determined from the totality of the circumstances of a particular case. The reasonableness of the inspection must vary with the nature of the thing to be inspected and the nature and gravity of harm which it sought to be averted. Furthermore, one factor to be considered in assessing the reasonableness of an inspection must necessarily be the knowledge possessed by the inspector. An average consumer may legitimately establish a minimum standard

below which an individual inspector will not be allowed to fall. Where the inspector possesses perception, knowledge, intelligence, or judgment superior to the average consumer, the law will demand performance of him consistent with such knowledge and judgment, etc. Renown, Inc. v. Hansel, Phelps Construction, 201 Cal.Rptr. 242, 154 Cal. App. 3d 413 (Cal. Ct. App. 1984).

IV. THE STATUTE OF LIMITATIONS AS A DEFENSE TO SURETY'S LIABILITY FOR LATENT DEFECTS

One of the defenses that a surety may assert to a latent defects claim is the statute of limitations. However, as the following cases reveal, there is some question as to which statute applies and when the statute of limitations should begin to run. As evidence of this confusion, I submit the following four cases.

In the District School Board of Desoto County vs. Safe Co. Insurance Company, 434 So.2d 38 (Fla. 2d DCA 1983), the County asserted a latent defects claim against the surety. The court held that a certificate of substantial completion and the acceptance of the constructed building by the county began the one year statute of limitations period as provided by Florida Statute 255.05(2) for actions against surety on a bond. The court ruled that if the legislature had intended the existence of latent defects in the building to toll the beginning of the

naturally understood statute of limitations, the legislature would have designated a special statute. Thus, the architect's certificate of completion started the one year statute of limitation for bonds under 255.05.

In 1984, Florida's Third District Court of Appeal held a surety liable in Florida Keys Community College vs. Insurance Company of North America, 456 So.2d 1250. Within four years of completion of its building, the college instituted an action against the contractor and surety alleging latent construction defects. The trial court dismissed the claims against the surety on the ground that it had not been filed within the one year period of limitations set forth in 255.05. Upon review the appellate court found that the performance provisions of the bonds that were provided by the surety were broader than those required by statute in that the surety assumed the risk of negligence and of misconduct by employees of the contractor. (This is a warning to sureties that they should not deviate from what is specifically required by statutes.) Even though the bond was furnished pursuant to the Public Works Project Statute, the court construed the bond as a common law bond, which resulted in expanding the limitations period from the one year to the four years, and overturned the summary judgment against the college.

In School Board of Volusia County v. Fidelity Company of Maryland, 468 So.2d 431 (Fla. 5th DCA 1985), the School Board filed an action against the contractor and surety for

latent defects in the school's roof appearing more than eight years after the completion of the building. The court specifically avoided the issues of whether latent defects were covered under a performance bond after a building is completed, and whether the particular bond in question was a common law or a statutory bond. Instead, the court held that time periods for all applicable statute of limitations had run. Therefore, no action could be maintained by the School Board against the surety company.

An incredible case involving a surety's statute of limitations defense is Regents of the University of California v. Hartford Accident & Indemnity Company, 147 Cal. Rptr. 486, 581 P. 2d 197 (Cal. 1978). The work was substantially completed in the fall of 1962. Approximately ten years later, the Regents discovered that the project was beginning to deteriorate because of dry rot and was structurally unsafe. The University asserted causes of action against the contractor and surety based upon negligence, implied warranty, and breach of contract. The trial court granted summary judgment in favor of the contractor and surety based upon a statute of limitations defense. In a bizarre opinion, the appellate court found that all of the claims against the principal were barred by the statute of limitations; however, the surety was not among those parties protected by the ten year statute of limitations applicable to latent defects. The court further found that the obligation of the surety remained

notwithstanding the fact that the statute of limitations ran as to the contractor. However, the opinion does not stop there. It gets more bizarre. The court went on to find that the surety was not without remedy in that the primary remedy that a surety can invoke against the principal is a suit based upon the implied obligation of reimbursement. Thus, when the surety is compelled to pay under these circumstances, it can obtain reimbursement from the contractor. Furthermore, the court held the provision of the bond that stated: "that the liability of the principal and surety shall at all times, under all circumstances, be co-extensive" did not exonerate the surety when the statute of limitations period runs on the obligation of the contractor. Therefore, the surety may be sued directly by the School Board, and the surety may pursue the contractor under a separate cause of action of reimbursement. In sum, everyone is in the same predicament as if there was no viable statute of limitations defense.

V. **A SURETY MAY ASSERT ALL OF THE DEFENSES THAT THE PRINCIPAL HAS UNDER THE UNDERLYING CONTRACT.**

Unlike the California case, Florida has recognized that a surety may not be held liable where a contractor is not found to be liable. In Atlantic National Bank of Jacksonville vs. Modular Age, Inc., 363 So.2d 1152 (Fla. 1st DCA 1978), an obligee sued the contractor and the surety under its performance bond due to the failure of the motel's walls to

meet the building code. The court found that the architectural drawings, which were defective, were not the responsibility of the contractor. Thus, the failure of the walls to meet the building code was not due to the fault of the contractor and therefore, the surety could not be held liable.

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